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No. 91-181

FILED
SEP 19 1991
OFFICE OF THE CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1991

AGRO SCIENCE CO., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

KENNETH W. STARR
Solicitor General

SHIRLEY D. PETERSON
Assistant Attorney General

KENNETH L. GREENE
KIMBERLY S. STANLEY
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 514-2217

QUESTION PRESENTED

Whether under Section 174 of the Internal Revenue Code petitioners may deduct from gross income the full amount of cash paid, and the face amount of promissory notes issued, with respect to a research and development tax shelter when the promissory notes did not constitute genuine indebtedness and petitioners did not enter into the transactions with the intent to make a profit.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A9) is reported at 934 F.2d 573. The memorandum opinion of the Tax Court (Pet. App. A10-A48) is reported at 58 T.C.M. (CCH) 1093.

JURISDICTION

The judgment of the court of appeals was entered on March 25, 1991. Petitioners' petition for rehearing was denied on April 22, 1991 (Pet. App. A49). The petition for a writ of certiorari was filed on July 19, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners are three partnerships that invested in a research and development tax shelter organized by Coral Sociedade Brasileira de Pesquisas e Desenvolvimento, Ltd. (Coral), a Brazilian corporation. In 1982, Coral agreed to produce a different monoclonal antibody (MAB) conjugate for each of the partnerships.[1] In exchange, petitioners each paid $75,000 in cash and executed a promissory note (Research Notes) denominated in Brazilian currency then equivalent to $525,000. The Research Notes were payable over a four-year period beginning at the end of the seventh year after the execution date and bore interest at an annual rate of 10%. Although it was well known that Brazil's currency was continually undergoing dramatic devaluation due to hyperinflation, the Research Notes were not indexed for inflation, did not contain any other monetary correction provision, and bore an interest rate far below the market rate in Brazil. This contravened standard Brazilian commercial practice. Due to the extraordinary rates of inflation that prevailed in Brazil, and the resulting devaluation of the Brazilian cruzeiro against the dollar, each Research Note executed in 1982 could have been repaid in 1988 for approximately $184. Pet. App. A3-A5.

Coral promoted the MAB projects primarily as tax shelters, stressing to petitioners the tax advantages of executing the Research Notes (Pet. App. A4). The partners were unconcerned about the financial condition of their respective partnerships or their fellow

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[1] A MAB conjugate is a laboratory copy of a disease-fighting component found in man and certain animals (Pet. App. A3 n.1).

partners, and they had a shallow or nonexistent understanding of—the potential profitability, liability, or management of the partnership. Most partners knew little about the "research" performed on their behalf, but they were aware of the cruzeiro devaluation and the promised tax benefits of the shelter. *Id.* at A7.

2. On their 1982 and 1983 returns, petitioners deducted the entire purported $600,000 obligation to Coral (*i.e.*, the $75,000 payment plus $525,000 with respect to the Research Note), plus interest and expenses, as a research and development expense under Section 174 of the Internal Revenue Code. These deductions were passed through to petitioners' partners. The Commissioner disallowed the deductions because the Research Notes did not represent genuine indebtedness, because the Coral projects did not involve "research or experimental expenditures" within the meaning of Section 174, and because petitioners did not enter into the Coral transactions with a bona fide profit motive. Pet. App. A3, A10-A12.

Petitioners sought review in the Tax Court of the Commissioner's determinations. The Tax Court upheld each of the Commissioner's contentions with detailed findings and sustained the partnership adjustments. Pet. App. A10-A48.

3. The court of appeals affirmed. Pet. App. A1-A9. The court held that, because the Research Notes had no monetary correction provision, they were, as anticipated, virtually worthless at the time payment became due and the promoters and investors were well aware of, and based their investment decision upon, that fact. *Id.* at A5. The court concluded that the Research Notes represented "hollow debt[s]" that were created solely for the purpose of generating tax savings. *Id.* at A5-A6.

The court of appeals also upheld the Tax Court's finding that petitioners did not enter these transactions for profit. Pet. App. A6. The court ruled that the Tax Court's reliance on objective factors delineated in Treas. Reg. § 1.183-2(b) to establish the absence of profit motive was appropriate and that the Tax Court's evaluation of the totality of the evidence was not clearly erroneous. Pet. App. A6-A7. The court rejected petitioners' argument that profit motive should have been discerned by looking at each investor individually, holding that the issue of profit motive was properly determined at the partnership level. *Id.* at A8-A9.

ARGUMENT

The court of appeals correctly held that petitioners are not entitled to any deductions flowing from the Coral tax shelter "investments" because the Research Notes did not represent genuine indebtedness and because the partnerships did not enter into the transactions with a bona fide intent to make a profit. The court's decision does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. This Court has long held that, if indebtedness has no reality or substance apart from anticipated tax benefits, it is to be disregarded for tax purposes. *Knetsch* v. *United States*, 364 U.S. 361, 366 (1960). Neither the deduction for expenses supported by false debt nor that for putative interest on the debt is allowable. *United States* v. *Campbell*, 897 F.2d 1317 (5th Cir. 1990); *Levin* v. *Commissioner*, 832 F.2d 403 (7th Cir. 1987); *Goldstein* v. *Commissioner*, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967). Courts have uniformly concluded that prom-

issory notes with deferred payments stated in foreign currencies that are likely to decline in value precipitously in relation to the United States dollar lack economic substance and are to be disregarded. *United States* v. *Campbell*, 897 F.2d at 1321; *Levin* v. *Commissioner*, 832 F.2d at 407.

The Research Notes in this case lacked economic substance because they bore no relationship to standard business practice in Brazil in 1982. Pet. App. A5. Although the notes were not due to be paid until seven years after execution—and then came due in four annual installments—they did not contain any index for inflation or other monetary correction provision to account for the precipitous devaluation of the Brazilian cruzeiro. Thus, at the time the first payment on the promissory notes became due, the entire obligation that petitioners would treat as $525,000 could have been satisfied for a mere $184. *Id.* at A4. Furthermore, the 10% interest rate provided for by the notes was less than one-tenth of the fair market interest rate in Brazil at the time the notes were executed. *Id.* at A5. The promoters of the Coral tax shelter, as well as the investors, were well aware that the spiraling Brazilian inflation would protect the issuers from any true liability on what appeared to be very large notes. *Id.* at A7. Thus, at no time did petitioners expect to pay the $525,000 expense claimed on their tax returns.

2. Petitioners contend (Pet. 17-20) that the court's holding "abandoned" the principle of accrual accounting and is therefore inconsistent with *United States* v. *Hughes Properties, Inc.*, 476 U.S. 593 (1986). In that case, the accrual basis taxpayer operated progressive slot machines. A progressive machine has a jackpot that increases as money is gambled on the

machine, and the potential jackpot is registered on a "payoff indicator" on the face of the machine. The taxpayer deducted the amount shown on the "payoff indicator" on the face of each machine at the end of its tax year. The Commissioner disallowed the deduction on the basis that the taxpayer's liability for the progressive jackpots was not fixed and certain by the end of its tax year because there existed no person who could assert any claim to the funds. This Court held, however, that because state law required that the jackpot be paid out, the liability was fixed and certain. *Id.* at 601. The remote possibility that the jackpot might never be won did not change that fact. *Id.* at 601-602. This holding of *Hughes Properties*, of course, stands in stark contrast to the instant case, which involves a sham research debt that was created for the sole purpose of generating tax savings.[2]

Petitioners also err in contending (Pet. 18) that the decision in this case is contrary to the Tax Court's reasoning in *Levin* v. *Commissioner*, 87 T.C. 698 (1986), aff'd, 832 F.2d 403 (7th Cir. 1987). To be sure, the court noted in *Levin* that, when an obligation is stated in foreign currency and is thereafter satisfied at a lower dollar cost than originally reported, the taxpayer is to recognize gain in the year the debt is satisfied. 87 T.C. at 729 n.19. Petitioners fail to note, however, that the Tax Court in *Levin* rejected the very argument that petitioners raise in this case, for the court held that when a debt lacks

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[2] As petitioners note (Pet. 18), Congress recently addressed the tax effects of the use of foreign currency in transactions arising in years after those in issue. See 26 U.S.C. 985-986. These provisions have no application to transactions that lack economic substance.

economic substance and is therefore to be disregarded for tax purposes, the accounting treatment of the purported debt is irrelevant: "[o]nly if the debt is found to be genuine does the question of its proper accounting treatment arise." *Id.* at 729.

3. Petitioners also challenge (Pet. 11-12) the court's finding that they did not enter into the Coral transactions with a bona fide intent to make a profit. To be deductible under Section 174, expenses for research must be incurred in connection with the taxpayer's "trade or business." *Snow* v. *Commissioner*, 416 U.S. 500, 502-503 (1974); *Mayrath* v. *Commissioner*, 357 F.2d 209, 212 (5th Cir. 1966). "[T]o be engaged in a trade or business, * * * the taxpayer's primary purpose for engaging in the activity must be for income or profit." *Commissioner* v. *Groetzinger*, 480 U.S. 23, 35 (1987). See *Mayrath* v. *Commissioner*, 357 F.2d at 212.

As the court of appeals correctly held (Pet. App. A7), the record establishes that petitioners entered into the Coral tax shelter primarily for the perceived tax benefits. The court noted that (i) the partners were unconcerned about the financial condition of their respective partnerships or their fellow partners, (ii) the partners had a shallow or nonexistent understanding of the potential profitability, liabilities, or management of the partnerships, (iii) most partners knew little or nothing about the research conducted for them by Coral, and (iv) some partners attended one partnership meeting while others knew nothing about partnership meetings (*ibid.*).

Petitioners do not dispute the accuracy of the court's findings, but mistakenly argue (Pet. 11-12) that these factors are "totally irrelevant" because they were drawn from Treas. Reg. § 1.183-2(b), which pro-

vides a list of objective factors to be used to determine whether a taxpayer's activity is engaged in for profit. The legislative history of Section 183 of the Code, however, which is echoed in Treas. Reg. § 1.-183-2(b), states that objective factors should be used to determine whether an "inventor" possesses a profit motive. See S. Rep. No. 552, 91st Cong., 1st Sess. 103-104 (1969). The inclusion of "inventors" in both the legislative history and the regulations under Section 183 refutes petitioners' assertion that the objective factors listed in the regulation are not to be used to determine the profit motivation of a partnership engaged in research and development activities. Indeed, the objective factors discussed in Section 183 and Treas. Reg. § 1.183-2(b) have routinely been applied to tax shelters claiming Section 174 research and development expenditures. See, *e.g.*, *Smith* v. *Commissioner*, 91 T.C. 733, 754-755 (1988).

Petitioners also err in suggesting (Pet. 12-13) that the use of objective factors to determine the profit motive of a research and development partnership contravenes this Court's ruling in *Snow* v. *Commissioner*, *supra*. In *Snow*, the Court held that there was no need to resort to the objective criteria under Section 183 to evaluate the claimed deduction in that case because it was clear that "profit motive was the sole drive of the venture." 416 U.S. at 504.[3] The Court did not suggest in *Snow* that objective criteria are irrelevant when profit motive is in genuine dispute.

Finally, petitioners assert (Pet. 13-15) that profit motive should not be determined at the partnership

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[3] Petitioners suggest (Pet. 12-13) that tax motive is *always* an essential element of research and development activity. Even if true, that provides no justification for allowing deductions with respect to transactions, such as the instant transactions, that are driven solely by tax considerations.

level but, rather, separate determinations should be made with respect to each individual investor. It is well settled, however, that the issue of profit motive and the status of an activity as a trade or business must be resolved at the partnership level. *Tallal* v. *Commissioner*, 778 F.2d 275, 276 (5th Cir. 1985); *Polakof* v. *Commissioner*, 820 F.2d 321, 323 (9th Cir. 1987), cert. denied, 484 U.S. 1025 (1988); *Brannen* v. *Commissioner*, 722 F.2d 695, 703-704 (11th Cir. 1984); *Madison Gas & Electric Co.* v. *Commissioner*, 633 F.2d 512, 517 (7th Cir. 1980). Accordingly, the courts below properly focused on the partnerships in determining that these transactions lacked any profit motive.[4]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

SHIRLEY D. PETERSON
Assistant Attorney General

KENNETH L. GREENE
KIMBERLY S. STANLEY
Attorneys

SEPTEMBER 1991

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[4] Petitioners complain (Pet. 15-16) that it was improper for the Tax Court to deny deductions under Section 174 on the ground that the production of MABs by Coral did not constitute "research" within the meaning and intent of that Section. Since the Tax Court's holding on this issue was not a basis on which the court of appeals affirmed, this argument does not merit further review by this Court.

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